Statement of
David R. Malpass before the
House Rules Committee
Subcommittee on Legislative and Budget Process
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Chairman Pryce, members of the subcommittee, thank you for the invitation to testify on economic and budget issues and the forecasting of federal receipts and expenditures.

While working for the U.S. government and, since 1993, for Bear Stearns, I've looked carefully at the growth process in countries around the world. Part of my job is to find countries and financial markets that I think will do well.

Tax and spending systems, particularly tax rates, play a critical role in our evaluation. In general, countries with low or declining tax rates do better than countries with high or rising tax rates, and it shows up in their financial market performance, their economic growth rates, and the growth in their median incomes. In the same way, countries where government spending is a smaller portion of the economy do better than countries where government spending is a larger portion of the economy.

It is bewildering that the U.S. budget process runs on the assumption that policies on taxation and spending have no impact on the growth rate. All the evidence is to the contrary.

- In theory, Congress could consider, say, a 20% across-the-board increase in tax rates, and the current scoring system would assume the GDP growth rate would be unaffected.

- Against all reason, the U.S. budget process is set up so that a major tax simplification would be scored as if it had no effect on the long-term economic growth rate. From a procedural standpoint, the legislation would face a steep uphill battle because of these scoring assumptions.

- Congress could, in theory, propose a 10% across-the-board increase in spending, or a massive new entitlement, and rely on a scoring system that assumes no resulting slowdown in economic growth. The debate would be biased toward bigger government by a low-ball cost estimate.

- In the extreme, the scoring system is based on the assumption that an economy which was 100% government and 0% private sector would grow as fast as our current economy. To emphasize this point, our current scoring system is neutral on whether socialism or capitalism causes more economic growth.

As a result, the U.S. budget system is set up with a heavy bias in favor of higher tax rates and more government spending, leaving U.S. GDP and the median income less than what could be achieved.

- We labor under a tax code that is out of control, an abomination as Treasury Secretary Paul O'Neill calls it, yet we have a process that systematically thwarts any constructive tax reform by assuming that the reform wouldn't have any impact on the economic growth rate.

- We have a federal government that now spends nearly $2 trillion per year, much of it committed to perpetual growth through entitlements, yet assume that major new commitments will leave the economy unaffected.

- Clearly, the scoring process is broken.

It is true that economic forecasting isn't an exact science:

- Economic growth rates are hard to forecast. We've seen a dramatic example of that already this year with the 5.8% first quarter growth rate, compared to the Blue Chip December consensus of 0.4% for the first quarter.

- Government budget balances are even harder to forecast, because they are sensitive to both economic growth rates and hard-to-predict policy changes. CBO's January budget estimate for FY02, which ends in just a few months, was for a $21 billion deficit. By early March, that deficit estimate had changed to a $5 billion *surplus* due to an improved economic outlook, in part due to the growth effects of the 2001 tax cut. By late March, CBO's FY02 estimate was a $46 billion deficit, due mostly to the March stimulus bill. Now some estimates place the FY02 deficit at $100 billion due to the farm bill, weaker-than-expected tax receipts in April and the size of the coming supplemental appropriations bill.

- Thus, the budget process pretends to a degree of precision which simply isn't possible. CBO has tried to introduce scenario analysis into its budget estimates, but, unfortunately, point estimates are still dominating the process.

However, the scoring decision is a very different economic challenge. The proper scoring question is whether a given tax rate change will cause more or less economic growth and then to estimate the magnitude. **In our current system, we make the patently false assumption that there is no economic impact from tax changes.**

CBO, for example, seemed to ignore the 2001 tax cut in its thinking about the long-term U.S. growth outlook:

- In January 2000, CBO forecast a 2.8% expected growth rate in the ten-year window. In January 2001, CBO increased its ten-year forecast to 3%. It explained: "CBO has raised its projections of both potential and actual GDP over the past few years in response to the investment boom of the late 1990s, evidence of the economy's faster growth of productivity, and changes in the data used to calculate GDP." Note that there was no mention of the 1997 capital gains tax rate cut. In August 2001, CBO maintained its 3% forecast for 2001 – 2011. In its explanation, it studiously avoided any mention of the just-passed tax bill: "Nevertheless, CBO's medium-term outlook incorporates several important changes. For example, the recent slowdown has reduced both current and expected rates of investment. Those declines, together with a reduction in projected surpluses, have led CBO to modestly lower its medium-term projection of labor productivity growth. That revision is offset, however, by an increase in the projection of labor force growth."

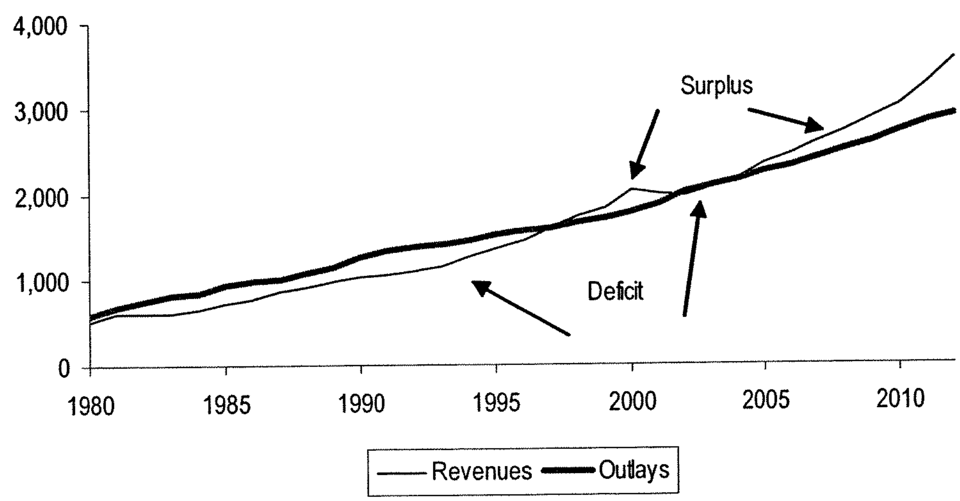
In sum, I think the first step is for the Administration, CBO and others to show in detail how they would revise their economic forecasts in the event of a material change in the tax code – something like an Economic Impact Statement. This could then be the subject of hearings and public debates. **At some point, Congress has to decide whether and how it thinks the tax system, tax rates and the size of government impact economic growth. If instead we continue the current process assuming major fiscal changes have no economic impact, I think we will remain mired in our current tax code, harming the economy.**

BUDGET TRENDS

The federal budget reflects tremendous growth in spending and even faster growth in federal receipts. The graph below uses CBO's March baseline forecasts for FY02, and points to both the ongoing increase in Federal spending as well as the sharp increase in taxation.

Taxation is heavy. Using CBO figures, federal revenues only fall slightly from the extremely high 20.8% of GDP recorded in 2000. It took over 200 years for the government to collect $1 trillion in annual revenues, the first time in 1990. It took only 10 years to double that to $2 trillion in annual revenue. Even with its assumption, I think faulty, that the 2001 tax cut didn't help the economy, CBO is projecting that the federal government which reach $3 trillion in annual revenues by 2010.

Federal Receipts and Expenditures

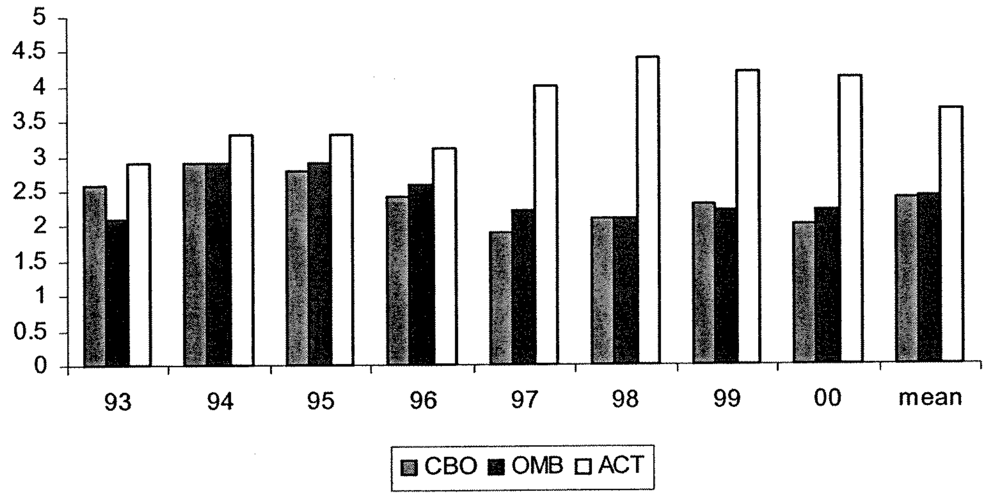


Source: CBO; Bear, Stearns & Co.

The trend in the 1980s was to over-estimate growth and under-estimate the fiscal deficit. The trend in the 1990s was the reverse – to under-estimate growth and over-estimate the fiscal deficit. These trends applied to both public and private sector forecasters.

Real GDP growth averaged 3.6% in the 1996-2001 period, including the 2001 recession. Given the shallowness of the 2001 recession and the ongoing strength in productivity, economic growth in coming years is likely to also be strong. Even if we use an average growth rate of 3% going forward, the cumulative fiscal surplus is still large, as is the rate at which the national debt would decline.

Real GDP Forecasts: OMB and CBO vs. Actual



Source: CBO; Bear, Stearns & Co.

Looking forward, both OMB and CBO are using what I think are conservative economic assumptions in their current budget forecasts. Their base case scenarios assume that growth falls back to an average rate of around 3.1% by 2005 or so. That is probably too conservative:

- Real GDP averaged over 3.6% during the 1996-2001 period, including the 2001 recession.
- Excluding the recession year of 2001, the 1996-2000 growth rate was 3.8%
- Growth averaged 3.5% per annum during the period 1948-2001.

Dynamic Response

The positive feedback from tax rate cuts has been repeatedly documented. This includes the Mellon, Kennedy and Reagan tax cuts. The harm from tax rate increases was shown clearly in the 1970s as inflation pushed people into higher tax brackets (before they were indexed.) Researchers have shown that revenue losses due to the Kennedy and Reagan tax cuts were much less than had been expected. The ensuing economic growth rates were much stronger than had been expected prior to the tax rate cuts.

- The American Council for Capital Formation determined, based on separate studies by Alan Sinai of Primark and David Wyss of Standard and Poor's that "A soundly structured, broad-based cut in tax rates on capital gains would significantly benefit all Americans. By reducing the cost of capital, it would promote the type of productive business investment that fosters growth in output and high-paying jobs. By increasing the mobility of capital, it would help assure that scarce saving is used in the most productive manner. By raising capital values, it would help support values in capital asset markets in general and the stock market in particular. By increasing the availability and lowering the cost of capital, it would aid entrepreneurs in their vital efforts to keep the United States ahead in technological advances and translate those advances into products and services that people need and want. By reducing taxes on their savings, it would treat fairly those thrifty Americans who must bear a heavier tax burden than the profligate. And, because of the combined impacts of unlocking and macroeconomic feedback, a broad-based capital gains tax cut is likely to increase federal revenues."

- Representative Paul Ryan (R-WI) wrote in the July/August 2001 Tax Foundation "More recently, evidence from the 1997 capital gain tax reduction from 28 percent to 20 percent, shows that the Treasury did not suffer. In fact, by contributing to the largest gain in productivity and capital investment in a decade, it increased tax receipts to the Treasury by 66 percent in just three years. Projected revenue gains following the tax cut were $55 billion for 1997, $64 billion for 1998, and $75 billion for 1999. Actual revenue gains were tens of billions of dollars higher: $79 billion for 1997, $90 billion for 1998, and $110 billion in 1999."

- A study of capital gains tax cuts by the Massachusetts Tax and Administration Department showed clearly that a lower capital gain tax rate led to higher revenues at both the state and federal level. It also found that lower state income taxes led to an increase in the GSP.

Others have noted the positive impact of tax cuts.

- The Heritage Foundation's dynamic model projects 0.2% per annum higher growth as a result of the Bush tax cuts. Their model projected that the estimates of the "price tag" should have been $939 billion over ten years, not the CBO's static $1.62 billion.

- From Heritage: "Martin Feldstein of Harvard University (in February 2001 Congressional Testimony) also has estimated that the Bush tax cut would result in a substantial supply-side effect. According to his calculations, additional economic growth would boost tax revenues by $400 billion to $600 billion. Counting this supply-side effect, Feldstein estimates that the revenue impact of the Bush tax cut is actually $1.2 trillion or less."

- Martin Feldstein wrote in the December 6, 1999 *Wall Street Journal*: "Any sensible estimate of the effect of tax rate reductions on government revenue would take into account their favorable impact on work effort, skill development, risk-taking and other factors that increase taxable income. But the strange rules adopted by Washington's official revenue estimators ignore these favorable effects, making tax-rate cuts look more expensive than they turn out to be in practice. I estimate that such favorable feedback effects would offset about onethird of the traditionally estimated revenue loss from cutting the top tax rate to 33% from 39.6% as Mr. Bush proposes. The governor nevertheless opted to use the traditional scorekeeping rules in order to avoid any challenges to his claim that the tax cut fits responsibly within the available budget surpluses."

Tax Cuts Abroad

It's clear that reducing tax rates has had a positive economic impact on foreign economies as well. In a November 1998 NCPA Policy Brief #283, Alan Reynolds studied 50 countries that cut tax rates in the 1980s. He concluded that growth of real GDP was far more rapid among countries with low and/or falling tax rates.

In my country reports for Bear Stearns' clients, it's clear that tax rate changes have had a dramatic impact on our outlook. Here are some examples from our research reports:

- **2001 Global Recession**: We noted in March 2001 that "A combination of high real interest rates, expensive oil, and heavy taxation has been subtracting from world growth, depressing financial markets. The global slowdown is increasingly circular. If the policy variables were to improve - monetary policy, oil prices, and tax rates - we think a global re-acceleration and financial market recovery would begin."

- **Argentina**: In December 1999, we wrote that "Rumored tax increases include excise tax increases, an extension of the VAT tax, and a higher income tax for the wealthy. Each of these would, in our view, be harmful to Argentina's growth and investment rates" and "In 1999, VAT tax collections through November were down 10.3% from the same period in 1998. Our view is that Argentina is well beyond Laffer curve optimization with its 21% value-added tax rate. Faced with a 21% VAT tax, the logical choice is to avoid it. This can be done legally by reducing labor and consumption and increasing leisure time. The result: high unemployment, a weak economy, and weak tax collections." (Argentina's tax revenues collapsed in 2000-2002, contributing to its January 2002 devaluation and economic meltdown.)

- **Turkey**. In February 2001 (after Turkey's massive devaluation), we wrote: "The roots of this recent crisis are the anti-growth economic policies that the IMF pressed on Turkey in exchange for an $11.4 billion credit line. When you consider just some of the tax increases that Turkey agreed to in late-2000, it's not surprising that the economy has taken a hit and the government is under pressure":

    1. Raise the corporate tax rate to 25% from 20%
    2. Increase withholding rates on bank deposits and other financial transactions

3. Reintroduce "presumptive" income taxation. This is a tax based on living standards
4. Reduce the current rates of indexation of income tax brackets.
5. Increase the VAT for natural gas and telephone services, and increase automobile taxes
6. Extend the prepayment of quarterly taxes by corporations and individuals
7. Increase fees on import credit, as well as on the Istanbul stock exchange

- **Mexico**. In November 2001, we wrote about Mexico's proposed tax reform: "Stage two also includes a cut in income tax rates. Eliminating exemptions and reducing tax rates would not only add to Mexico's growth rate, but would also bring in more revenues to the government." And "While it's clear that convergence is a powerful force for Mexican growth, the growth rate is not simply a captive of the US business cycle. Mexican fiscal policy affects growth at the margin. Higher taxes hold down growth not only through fiscal drag, but also by using up President Fox's political capital and attention. This is already becoming clear by the reduced emphasis on a needed income tax reform, but also through the lack of progress on sectoral reform.

- **Russia** cut personal income tax rates to a flat 13% in 2000, fuelling an economic rebound and a budget surplus. The Russians moved to cut corporate tax rates to 24% from 35% in January 2002, which should help keep growth healthy.

In conclusion, each Wall Street economist has a unique way of thinking about the connection between government actions and the economic growth rate. My view is that higher tax rates slow growth while lower tax rates accelerate growth. I think this has been amply proven. The current U.S. budget process denies this conclusion, assuming instead that changes in the tax system have no impact on economic growth. I think the process has to be changed in order for the U.S. to stay at the forefront of the global economy.